TABLE 1

FREQUENCY OF PROVISION OF 1986 PRICE DATA FOR FCC SAMPLE OF 419 SYSTEMS

System Served Franchise Area in 1986	1986 DATA Complete	Incomplete	TOTAL
Yes	175	93	268
No	0	109	109
No response	0	42	42
TOTAL	175	244	419

TABLE 2

COMPARISON OF REAL 1986 REVENUE PER SUBSCRIBER CHANNEL WITH RATES THAT WOULD HAVE BEEN ALLOWED UNDER 1992 BENCHMARK RATES

	Rates Regulated in 1986			Rates Not Regulated in 1986			Total			
	1992 Benchmark Rate Using 1986 System Attributes > Real 1986 Rate	1992 Benchmark Rate Using 1986 System Attributes < Real 1986 Rate	1992 Benchmark Rate As A Percentage of Real 1986 Rate	1992 Benchmark Rate Using 1986 System Attributes > Real 1986 Rate	1992 Benchmark Rate Using 1986 System Attributes < Real 1986 Rate	1992 Benchmark Rate As A Percentage of Real 1986 Rate	1992 Benchmark Rate Using 1986 System Attributes > Real 1986 Rate	1992 Benchmark Rate Using 1986 System Attributes < Real 1986 Rate	1992 Benchmark Rate As A Percentage of Real 1986 Rate	Annualized Real Price Increase
Overbuilds	3	1	119% *	6	1	140% *	9	2	132% *	4.77% **
Municipal systems	2	1	166% *	1	3	102% *	3	4	129% *	4.40% **
Less-Than-30 Percent Penetration	6	1	122% *	4	4	132% *	10	5	127% *	4.08% **
Not "competitive"	47	17	126% *	59	19	138% *	106	36	132% *	4.80% **
Weighted Total	58	20	127% *	70	27	136% *	128	47	132% *	4.72% **

* These percentages are not significantly different from one another at a critical value of 5 percent.
** These growth rates are not significantly different from one another at a critical value of 5 percent.

**KPMG PEAT MARWICK COMMENTS ON
FCC DISALLOWANCE OF NONCORPORATE INCOME TAXES
IN COMPUTING RATES OF RETURN**

The Federal Communications Commission, in its July 15, 1993 Notice of Proposed Rulemaking MM Docket No. 93-215 ("NOPR"), recognizes the treatment of federal and state income taxes as an expense. A footnote expands on this treatment to disallow noncorporate taxes. "Taxes would include only those payable by the business entity. Income taxes payable on income from cable operations by individual owners, partners or Subchapter S Corporation owners would not be recoverable rates for regulated cable service."[1] The complete disallowance of income taxes paid by noncorporate cable operators is inappropriate given the financial structure of the cable television industry.

An allowance for income tax expenses of regulated noncorporate taxpayers has not been a major policy issue for regulators because few regulated public utilities operate in noncorporate form. There are sound business reasons for traditional regulated utilities to use the corporate form that include the minimization of any potential liability exposure, and the ability to obtain greater access to capital markets. One characteristic of regulated public utilities, as defined in the Internal Revenue Code, is that they are corporations.[2] Those regulated public utilities that do operate in partnership form are often owned solely by other corporate regulated public utilities.[3] Thus, in general, regulators are not often required to address the issue of income taxes paid by a regulated public utility operating in noncorporate form.

The general theory of allowing regulated public utilities to recognize income taxes as an expense is that ratepayers should fully compensate the utility for taxes imposed directly on the entity, but should not provide compensation for income taxes imposed on individual investors in the utility. Thus corporate regulated public utilities are fully compensated for corporate

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[1] See NOPR paragraph 30 and footnote 32, page 17.

[2] See Internal Revenue Code Section 7701(a)(33) where regulated public utilities are defined as corporations performing one or more specified services, if the rates have been established or approved by certain governmental or political entities.

[3] This paper does not directly address the treatment of income taxes paid on partnership interests held by corporations. Such partnership income is fully subjected to corporate income taxes just as if the entity were itself a corporation. It would seem that the Commission would find that a full allowance for these corporate income taxes paid on the earnings of a noncorporate entity to be noncontroversial. See, for example, the Federal Energy Regulatory Commission's (FERC) treatment of income taxes for Great Plains Gasification Associates, a partnership of 5 corporate affiliates of pipeline companies under FERC's jurisdiction, 9 F.E.R.C. P61,221 (1979). The FERC order stated that "For accounting and rate purposes, Great Plains, a partnership, will be treated as if it were a corporation and comprehensive tax allocation procedures will be required."

income taxes, but shareholders are not compensated for personal income taxes on distributed earnings.

When an issue has arisen regarding the treatment of noncorporate income taxes, regulators and the courts have in some cases allowed, and in other cases disallowed, the recognition of these taxes as an expense. In a case before the Texas Supreme Court, *Suburban Utility Corporation*[4], the Court ruled that noncorporate taxes must be allowed as an expense for an S-corporation. In *Vernah S. Moyston*[5], before the New Mexico Supreme Court, the Court required sole proprietor taxes to be treated as an income tax expense. Other cases that did not allow income tax expense were decided on the basis of a lack of evidence rather than a disagreement over the appropriate treatment of such taxes. In *Greely Gas*[6], the Court of Appeals of Kansas agreed that an S corporation, such as Greely, should be allowed to treat income taxes paid by shareholders as an expense; however, the Court also found that Greely did not provide the Court with evidence necessary to support the actual income tax liability. This prior regulatory experience provides the Commission with a basis for allowing a noncorporate income tax expense for cable television rates of return regulations.

The cable television industry has numerous small operators principally owned by individual investors that operate as partnerships or S corporations where the income earned is subject to federal and state individual income taxes. (There are also a number of larger partnerships with corporate owners; e.g., the Denver cable television partnership was owned by Liberty Media Corp. and Time Warner.)

As the Commission recognized in the NOPR, the capital structure of the cable television industry is quite different from that of traditional regulated industries. This difference is critical in the treatment of income taxes.

> "The cable industry is still a relatively new industry, characterized by growth and reinvestment of earnings with the possibility that the expectations of investors in the cable industry differ from other regulated industries. Moreover, the cable

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[4] In *Suburban Utility Corporation v. The Public Utility Commission of Texas*, 652 S.W.2d 358 (Tex. 1983), the court found that "The income taxes required to be paid by shareholders of a Subchapter S corporation on a utility's income are inescapable business outlays and are directly comparable with similar corporate taxes which would have been imposed if the utility operations had been carried out by a corporation. Their elimination from cost of service is no less capricious than the excising of salaries paid to a utilities would be. We therefore hold that Suburban is entitled to a reasonable cost of service allowance for federal income taxes actually paid by its shareholders on Suburban's taxable income or for taxes it would be required to pay as a conventional corporation, whichever is less."

[5] *Vernah S. Moyston v. New Mexico Public Services Commission*, 76 N.M. 146, 412 P.2d 840, 846-51 (N.M. 1966).

[6] *Greely Gas Company v. The State Corporation Commission*, 15 Kan. App. 2d 285; 807 P.2d 167 (Kan. App. 1991).

industry, unlike industries such as telephone, relies heavily on private and semi-public sources of capital [footnote excluded]."[7]

A traditional regulated public utility earns income, pays tax on that income, and distributes a large percentage of after-tax income to shareholders as dividends. In contrast, cable television companies typically pay no dividends, which is in part attributable to their having little after-tax income[8], but also to the reinvestment of earnings to finance future growth.

Under current federal and state income tax rules, when dividends are paid to individual shareholders a second level of income tax may be paid. This second level may be paid even when earnings are retained by the corporation rather than distributed as dividends. These retained earnings increase the value of the company and are reflected in the price of the shares when those shares are ultimately sold.

At the federal level, the highest tax rate on ordinary income, including dividends, is 39.6 percent.[9] Capital gains realized by individuals are subject to a maximum federal tax rate of 28 percent.[10] To the extent shares are not sold, but are instead retained and ultimately included in the estate of the investor, the heirs will completely avoid income taxation of accrued capital gains through a tax-free step up in the basis of the shares. Thus retained corporate earnings will bear a lower tax rate, with that tax deferred until the shares are sold, and if the shares are held until death the tax is completely forgiven.

Corporate earnings attributable to other shareholders may bear only a slight additional income tax burden. Dividends paid to corporate shareholders are eligible for a dividends received deduction to minimize the extent of multiple taxation. Dividends and realized capital gains earned by tax-exempt entities, such as pension funds, bear no additional income tax burden. Foreign shareholders also pay little or no tax on their U.S.-source earnings. Subject to income tax treaty, foreign shareholders may pay modest withholding taxes on distributed dividends that generally range from 0 to 15 percent, and they are completely exempt from U.S. capital gains taxes. U.S. taxes that are paid by a foreign shareholder may be eligible for a credit against the investor's home country income taxes. Thus, a significant portion of corporate earnings may bear only a single, entity-level tax, and little or no shareholder tax.

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[7] See NOPR paragraph 49, page 26.

[8] For a discussion of the net earnings of the cable television industry, see "A Comparison of the Profitability of the Cable Television Industry with other Corporations," KPMG Peat Marwick, January 17, 1992.

[9] This top marginal tax rate is effective beginning in 1993 under the Omnibus Budget Reconciliation Act of 1993, which was signed into law by President Clinton on August 10, 1993.

[10] The Omnibus Budget Reconciliation Act of 1993 allows individuals who invest in the stock of small corporations, subject to certain conditions, to exclude up to 50 percent of any gain when the stock is sold, provided that the stock is held for at least 5 years.

Noncorporate cable operators owned directly by individuals experience a full income tax burden on all their net income without regard to whether it is retained or distributed. That is, these individuals are taxed at federal rates of up to 39.6 percent on 100 percent of the earnings of the business. The economic effect of these personal income taxes may equal or exceed the burden of income taxes on corporate earnings.

The attached worksheets provide simple examples of after-tax rates of return at the entity level and the investor level. The examples assume all taxpayers are subject to the highest statutory federal income tax rates, but ignore state income taxes. Capital gains taxes are assumed to be indefinitely deferred, which is equivalent to assuming a tax-free step up in basis at death. A more immediate taxation of capital gains would reduce the disparity in tax burdens, but the difference would still be significant. No debt is assumed; however, the addition of debt would not change the overall result assuming debt/equity ratios are constant in both corporate and noncorporate entities. A required return on equity of 20 percent at the entity level is assumed.

The results of this analysis show that by not allowing an adjustment for income taxes, investors in noncorporate entities are only treated equitably if compared with C corporations that distribute 100 percent of their earnings and whose investors are fully subject to tax. Otherwise, investors in partnerships and S corporations will be relatively worse off. Under the assumptions used, if only half the net income of a C corporation is distributed or, alternatively, if only half the shareholders are taxable, the after-tax rate of return to investors will be 16 percent for the C corporation and 12.1 percent for the partnership or S corporation. If both assumptions are combined such that half the earnings are distributed and half the shareholders are taxable, the return to noncorporate shareholders would still be 12.1 percent, while the return to C corporation shareholders would be 18 percent.

EXAMPLES OF RATES OF RETURN UNDER ALTERNATIVE FORMS OF BUSINESS

	Entity-level Return on Equity			Investor-level Return on Equity		
	Partnership	S Corporation	C Corporation	Partnership	S Corporation	C Corporation
All corporate earnings distributed and all taxable individual shareholders	20.0%	20.0%	20.0%	12.1%	12.1%	12.1%
50% corporate earnings distributed and all taxable individual shareholders	20.0%	20.0%	20.0%	12.1%	12.1%	16.0%
All corporate earnings distributed and 50% of shareholders are tax-exempt	20.0%	20.0%	20.0%	12.1%	12.1%	16.0%
50% corporate earnings distributed and 50% of shareholders are tax-exempt	20.0%	20.0%	20.0%	12.1%	12.1%	18.0%

Before making a final ruling, the Commission should carefully reconsider the treatment of noncorporate income taxes. In that the existing capital structure of the industry may result in the earnings attributable both forms of business being subject to comparable tax burdens it is appropriate to allow a full adjustment for noncorporate income taxes paid on sole proprietorship, partnership, and S-corporation earnings. To do otherwise would result in the Commission creating an incentive for noncorporate cable operators to organize as corporations solely to recover federal and state income tax expenses, which are allowed to any corporate cable operator.

Examples of Federal Income Tax Burden on Alternative Forms of Business

Assumptions:	
Initial investment	1,000
Individual tax rate	39.6%
Corporate tax rate	35.0%
After-tax retun on shareholder equity	20.0%
Percent of corprate earnings distributed	100.0%
Percent of earnings attributable to taxable shareholders	100.0%

Summary of results:	
Return of equity at entity level	
Partnership	20.0%
S corporation	20.0%
C corporation	20.0%
Return on owners' equity	
Partnership	12.1%
S corporation	12.1%
C corporation	12.1%

Partnership	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Partners' tax	79.2
Net income after tax	120.8
Partners' capital account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

S corporation	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Shareholders' tax	79.2
Net income after tax	120.8
Accumulated surplus account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

C corporation	
Pretax income	307.7
Corporate tax	107.7
After-tax income	200.0
Distributed income	200.0
Retained earnings	0.0
Shareholders' investment	
Beginning of year	1,000.0
Increase in retained earnings	0.0
End of year	1,000.0
Investors' tax on distributed income	79.2
Shareholders' after-tax income (assumes no tax on appreciation)	120.8

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Examples of Federal Income Tax Burden on Alternative Forms of Business

Assumptions:	
Initial investment	1,000
Individual tax rate	39.6%
Corporate tax rate	35.0%
After-tax retun on shareholder equity	20.0%
Percent of corprate earnings distributed	50.0%
Percent of earnings attributable to taxable shareholders	100.0%

Summary of results:	
Return of equity at entity level	
Partnership	20.0%
S corporation	20.0%
C corporation	20.0%
Return on owners' equity	
Partnership	12.1%
S corporation	12.1%
C corporation	16.0%

Partnership	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Partners' tax	79.2
Net income after tax	120.8
Partners' capital account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

S corporation	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Shareholders' tax	79.2
Net income after tax	120.8
Accumulated surplus account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

C corporation	
Pretax income	307.7
Corporate tax	107.7
After-tax income	200.0
Distributed income	100.0
Retained earnings	100.0
Shareholders' investment	
Beginning of year	1,000.0
Increase in retained earnings	100.0
End of year	1,100.0
Investors' tax on distributed income	39.6
Shareholders' after-tax income (assumes no tax on appreciation)	160.4

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Examples of Federal Income Tax Burden on Alternative Forms of Business

Assumptions:	
Initial investment	1,000
Individual tax rate	39.6%
Corporate tax rate	35.0%
After-tax retun on shareholder equity	20.0%
Percent of corprate earnings distributed	100.0%
Percent of earnings attributable to taxable shareholders	50.0%

Summary of results:	
Return of equity at entity level	
Partnership	20.0%
S corporation	20.0%
C corporation	20.0%
Return on owners' equity	
Partnership	12.1%
S corporation	12.1%
C corporation	16.0%

Partnership	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Partners' tax	79.2
Net income after tax	120.8
Partners' capital account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

S corporation	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Shareholders' tax	79.2
Net income after tax	120.8
Accumulated surplus account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

C corporation	
Pretax income	307.7
Corporate tax	107.7
After-tax income	200.0
Distributed income	200.0
Retained earnings	0.0
Shareholders' investment	
Beginning of year	1,000.0
Increase in retained earnings	0.0
End of year	1,000.0
Investors' tax on distributed income	39.6
Shareholders' after-tax income (assumes no tax on appreciation)	160.4

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Examples of Federal Income Tax Burden on Alternative Forms of Business

Assumptions:	
Initial investment	1,000
Individual tax rate	39.6%
Corporate tax rate	35.0%
After-tax retun on shareholder equity	20.0%
Percent of corprate earnings distributed	50.0%
Percent of earnings attributable to taxable shareholders	50.0%

Summary of results:	
Return of equity at entity level	
Partnership	20.0%
S corporation	20.0%
C corporation	20.0%
Return on owners' equity	
Partnership	12.1%
S corporation	12.1%
C corporation	18.0%

Partnership	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Partners' tax	79.2
Net income after tax	120.8
Partners' capital account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

S corporation	
Pretax income	200.0
Entity tax	0.0
Distributed net income	200.0
Shareholders' tax	79.2
Net income after tax	120.8
Accumulated surplus account	
Beginning of year	1,000.0
Undistributed income	0.0
End of year	1,000.0

C corporation	
Pretax income	307.7
Corporate tax	107.7
After-tax income	200.0
Distributed income	100.0
Retained earnings	100.0
Shareholders' investment	
Beginning of year	1,000.0
Increase in retained earnings	100.0
End of year	1,100.0
Investors' tax on distributed income	19.8
Shareholders' after-tax income (assumes no tax on appreciation)	180.2

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